Agenda Item No.____________

File Code No. 560.04

CITY OF SANTA BARBARA

COUNCIL AGENDA REPORT

AGENDA DATE: March 10, 2009

TO: Mayor and Councilmembers

FROM: Administration Division, Finance Department

SUBJECT: Airport Terminal Project Financing Update

RECOMMENDATION: That Council:

A. Receive an update on the Airport Terminal Project financing; and

B. Authorize staff to proceed with the sale of the project bonds.

DISCUSSION:

Background

On December 23, 2008, the Council authorized the issuance of up to $65 million of Airport bonds to finance the Airport Terminal project. At that time, staff noted that the issuance of the Airport bonds was significantly complicated or even precluded by the unfavorable and extremely volatile credit markets. Estimates at the time were that the interest rate on the Airport bonds would have been as high as 8%, assuming they could have been sold at all. Even though Council authorized the bond issuance, staff made it clear that issuance would have to wait for more favorable credit market conditions. It was hoped that this would occur sometime in the first quarter of 2009.

The December 23rd staff report noted that there was another potential factor – adjustments to the federal Internal Revenue Code application of "Alternative Minimum Tax" - which could favorably affect the Airport bond sale. Generally, the interest earned by bondholders on the municipal bonds is exempt from state and federal income taxes. However, while municipal airport bonds are technically tax-exempt bonds, because they are used to construct a facility that serves for-profit commercial activities (the airlines), the interest earned on airport bonds has for many years been subject to the federal Alternative Minimum Tax ("AMT bonds"). As a result, the interest rates on Airport bonds are higher than on traditional, non-AMT tax-exempt municipal bonds. In the current bond market, the interest rate on AMT bonds can be as much or more than a full 1% higher than non-AMT municipal tax-exempt bonds. The December 23rd staff report noted that the federal stimulus legislation might include a temporary suspension of the AMT provision on airport bonds. As we now know, the final stimulus legislation signed by President Obama on February 17th, 2009 does indeed include a temporary exemption of airport bonds from the

Alternative Minimum Tax. All new airport bonds issued in calendar years 2009 and 2010 will be fully tax-exempt for their entire life and will not be subject to the AMT. This is extremely welcome news as it immediately lowers our anticipated interest rate on the Airport bonds by as much as a full 1%.

The December 23rd staff report noted that the negative news in the credit markets was substantially offset by extremely good news on the project cost. On Tuesday, December 16, 2008, bids were opened for the main terminal project construction contract. As we hoped would be the case given the recessionary environment, the City received extremely favorable bids. The apparent low bid of $32.5 million is almost 29% below the engineers' estimate of $45.6 million. The second low bid is $34.9 million. Staff noted that it would be extremely unfortunate if we are not able to take advantage of these favorable bids due to the lack of available financing. The construction bids are valid for 90 days from the December 16th bid opening, giving us until March 16, 2009 to award the bid.

Current Status of Project and Financing

As mentioned above, issuance of the bonds has been on hold while awaiting passage of the AMT relief and better market conditions. While we now have the AMT relief and the market for municipal bonds appears to have stabilized and even improved, there is no way we will be able to issue the bonds prior to the March 16th bid award deadline. Therefore, we are left to choose between 1) allowing the bids to lapse and re-bidding when we actually sell the bonds and 2) awarding the construction contracts prior to the sale of the bonds. Given the extremely favorable bids already in hand, the real possibility that re-bidding would result in higher bids and the very high likelihood that the Santa Barbara Financing Authority will be able to sell the bonds at a reasonable interest rate of around 6% within the next 90 to 120 days, staff recommends that the City proceed with bid award even though the Santa Barbara Financing Authority has not yet sold the bonds.

If Council approves this approach, the City would essentially self-finance the project until the Santa Barbara Financing Authority is able to sell the bonds. Until the bonds are sold, project costs incurred and paid by the Airport would be loaned to the Airport Fund by the City. An Airport promissory note would be issued which would be purchased by and for the City's investment portfolio. This is identical to the way the City assisted the Airport with interim financing for the joint use rental car facility. This would use no monies from or have any impact on the City's General Fund. The Airport Fund would pay the City interest on the borrowed funds as they are drawn down. If the bonds are sold within the 90 to 120 day timeframe as staff believes is probable, it is likely that the Airport will need an advance of no more than $3 to $5 million.

Risks

Construction Bid Risk - While it is impossible to be certain, staff believes that re-bidding the project could result in higher, and perhaps substantially higher, bids. We have been and are rightfully concerned about the financing costs and obtaining a reasonable interest rate on the bonds but savings from lower financing costs can be quickly offset by higher project costs.

Financing Risks - It is important that the Council understand the risk associated with this recommended approach. If for any reason the Santa Barbara Financing Authority is unable to sell the bonds within a reasonable period of time, the City would be committed to self-financing a project of more than $50 million for an extended period of time. While the City certainly has sufficient cash and investments to do this, tying up this amount of money for a 20-year period of time is clearly not something the City would choose to do. While this risk must be clearly understood and acknowledged, staff believes it to be extremely unlikely that the Santa Barbara Financing Authority will not be able to sell the bonds sometime within the next two years. In fact, after discussions with the financing team including the City's underwriter (Morgan Stanley) and our financial advisor, we believe we will be able to sell the bonds at a reasonable interest rate (around 6% or less) within the next 90 to 120 days.

There are certain time constraints that must be kept in mind. Under federal tax law, the City has the right to reimbursement from the sale of tax-exempt bonds for project costs up to three years after the first project costs were incurred. In this case, it means the Santa Barbara Financing Authority would be allowed to sell tax-exempt Airport bonds for this project until approximately March, 2012. After that, the City would only be able to obtain reimbursement for the project costs using taxable debt. Also, as mentioned above, in order to take advantage of the tax-exempt AMT relief, the bonds will have to be sold in calendar years 2009 or 2010.

As mentioned above, evidence suggests that the tax-exempt bond market is showing some signs of recovery. For example, on February 11th, the San Diego Regional Building Authority sold $136.9 million of tax-exempt debt at an interest rate of less than 5.5%. What makes this interesting is that the San Diego deal had the exact same credit ratings as our deal has and will have. These are extraordinary times and the bond markets have been extremely thin and volatile. However, with the removal of the AMT penalty on airport bonds, staff is confident that the Santa Barbara Financing Authority will be able to sell the bonds within a short time after we are ready to do so.

Summary

Based on recent developments including the lifting of the AMT provision on tax-exempt airport bonds and an apparent loosening in the tax-exempt municipal bond market, staff believes that the risk of higher prices as a result of re-bidding the terminal construction contract outweighs the risk of a potential delay in bond issuance. That combined with our ability to self-finance the construction for a 6 to 12 month period of time, if necessary, leads staff to recommend that we proceed with bid award on March 10.

At its meeting on February 24, 2009, the Finance Committee voted unanimously to recommend this course of action to Council.

SUBMITTED BY: Robert D. Peirson, Finance Director

APPROVED BY: City Administrator's Office